

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

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SUBJECT: Alternative Investments  
Policy and Procedures

ITEM NUMBER: 4

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: July 8, 1998

INFORMATION: \_\_\_\_\_

PRESENTER(S): Mr. Desrochers

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**EXECUTIVE SUMMARY**

One of the 1997-98 objectives approved for the Investment Branch was to review, evaluate, and revise the policies and procedures for the Alternative Investment Program. The first element was to define the primary role of alternative investments. Staff and the advisor presented the components of the process at the May 1998 and June 1998 Investment Committee Meetings.

Attachment 1 contains policies to be used in the management of the alternative investment program. The policies are intended to guide the investment activities of the Board, and are designed to be static in nature. Policies will be returned to the Investment Committee prior to changes being implemented.

The policies 16 through 20 on page 5 of Attachment 1 reflect the changes as directed by the Investment Committee.

**RECOMMENDATION**

Staff and Pathway Capital Management recommend that the Investment Committee approve the Alternative Investment Policy Manual by adopting the attached resolution (Attachment 2).

## INTRODUCTION

In accordance with the Investment Management Plan, California State Teachers' Retirement System (STRS) has a commitment to illiquid equity and equity related funds actively managed by specialized professionals to achieve a total rate of return superior to public equity vehicles.

The portfolio holding these assets is identified as Alternative Investments. This portfolio can include limited partnerships, direct investments, co-investments, and secondary interests in the following market segments:

- Leveraged Buyout
- Venture Capital
- Distressed Debt
- Mezzanine Financing
- Natural Resources

The primary objective for the alternative investment portfolio is to provide enhanced investment returns over those available in the public market. The increased risk associated with the structure, liquidity, and leverage require a higher net total rate of return.

The STRS' Board established the asset allocation and strategic objectives for the alternative investment portfolio. The management of all types of investments are performed by internal and external professionals which are monitored and evaluated by internal investment officers and an external alternative investment advisor. The internal investment officers operate under the direction of the Chief Investment Officer or designee. The external alternative investment advisor reports directly to the STRS' Board.

This manual will establish the policies and procedures involved in the management of investment of Alternative Investments. The policies are designed to set boundaries for expected performance, diversification, and investment structure. The procedures are designed to provide guidelines for the implementation of the approved policies. A flow chart is provided to establish context for the policies and procedures presented.

## **ALTERNATIVE INVESTMENT PORTFOLIO POLICIES**

The following represent the approved policies to be utilized in the management of the alternative investment segment of the total investment portfolio. The policies are designed to set boundaries for the expected performance and structure. Policies approved by the STRS' Board cannot be altered without explicit direction from the STRS' Board.

1. The alternative investment portfolio of the California State Teachers' Retirement System is invested in a prudent manner for the sole benefit of STRS' participants and beneficiaries in accordance with the Teachers' Retirement Law and other applicable statutes.
2. The alternative investment portfolio shall be invested to provide enhanced investment returns. Generating high rates of return shall always be the primary objective with diversification being an ancillary benefit.
3. Diversification within the alternative investment portfolio is critical to control risk and maximize returns. The specific investments shall be aggregated, evaluated, and monitored to control unintended biases. Diversification can occur across the following parameters.
  - A. **Market Segment** -- The market segments are defined as Leveraged Buyout, Venture Capital, Distressed Debt, Mezzanine Financing, and Natural Resources.
  - B. **Vintage Group** -- Vintage group is defined by the closing of the limited partnership. Investments within market segments shall be stratified by vintage group to mitigate the impact of fund flow trends within each segment.
  - C. **Economic Sector** -- Economic sectors are depicted by the standard Value-Line categories such as finance, technology, medical health, or electronic.
  - D. **Geographic Location** -- Geographic regions are defined as the location of the head office of the company. The geographic breakdown is expressed as West Coast, Southwest/Rockies, Southeast, Northeast, Mid-West, Mid-Atlantic, United Kingdom, Europe, Canada, and Other International.
4. A strategic target and range shall be established for the market segment criteria. The target and range may change over time as conditions warrant as approved by the Investment Committee. The target and range criteria are included as Exhibit 1. The diversification criteria will be reviewed on an annual basis.

5. Investments shall not be approved for the sole purpose of aligning one specific diversification range. Projected rate of return, risk, and other policies shall receive consideration in addition to diversification.
6. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the alternative investment portfolio.
7. Authorization letters which indicate who may sign on behalf of STRS shall be included at the time of closing. Whenever a change in authorized signers take place, the limited partnerships shall be notified in writing within 24 hours in the event of termination and as soon as possible in the event of a newly authorized signer(s).
8. Prior to being processed by the Operations Area, all cash contribution and stock sales transactions tickets shall be signed by two Investment Officers.
9. Graduated limitations of daily trading authority for aggregate alternative investment portfolio transactions are as follows:
 

Associate Investment Officer	\$ 1 million
Investment Officer I	\$ 5 million
Investment Officer II	\$ 10 million
Investment Officer III	\$ 20 million
Director of Alternative Investments	\$ 50 million
Chief Investment Officer	\$200 million
10. The rejection decision for limited partnerships, direct investments, co-investments, and secondary interests is delegated to staff with the stipulation that all limited partnerships receive equal opportunity and subject to the appropriate amount of due diligence as defined in the alternative investment procedures.
11. The approval decision for “follow-on limited partnerships” is delegated to staff considering the following stipulations:
  - A. Applicable only to limited partnerships sponsored by general partner(s) included in the STRS' alternative investment portfolio.
  - B. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
  - C. Maximum amount of the commitment shall not exceed \$400 million or 20% of the total amount of the partnership capitalization, whichever is less.

- D. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
12. The approval decision for “new limited partnerships” is delegated to staff considering the following stipulations:
- A. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
  - B. Maximum amount of the commitment shall not exceed \$100 million or 20% of the total amount of the partnership capitalization, whichever is less.
  - C. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
13. The approval decision for co-investments is delegated to staff considering the following stipulations:
- A. Co-investments shall be made on the same (or better) terms and conditions as provided to the partnership.
  - B. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
  - C. Maximum amount of the commitment shall not exceed \$50 million or 30% of the STRS' commitment to that partnership, whichever is less.
  - D. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
14. The approval decision for “secondary limited partnership” interests is delegated to staff considering the following stipulations:
- A. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
  - B. Maximum amount of the commitment shall not exceed \$50 million or 20% of the total amount of the partnership capitalization, whichever is less.
  - C. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
15. Distributions received in the form of stock shall be managed as identified in the alternative investment procedures. All sales will be subject to the trading limitations shown in the internal equity policy and procedure manual.

16. The April 1, 1998 and May 6, 1998 alternative investment presentations to the Investment Committee, including procedures and desk manual, are incorporated into this policy by reference.
17. The approval decision under delegation as it relates to new limited partnerships, follow-on limited partnerships, co-investments, and secondary limited partnership interests shall be completed following a positive written recommendation by the alternative investment advisor and STRS' staff. The investment analysis and due diligence will be conducted in the same manner as previously reviewed by the Investment Committee.
18. The alternative investment portfolio performance benchmark shall be the Consumer Price Index plus 12 % as approved in the 1997 Asset Allocation Review.
19. The alternative investment portfolio will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification targets, and a resource allocation budget.
20. The alternative investment advisor will prepare and present a portfolio management report on a semi-annual basis. The management report will provide portfolio diversification, largest holdings, common holdings, partnership performance, and committed and funded status.

Adopted on June 3, 1998

Amended on \_\_\_\_\_

RESOLUTION OF THE  
TEACHERS' RETIREMENT BOARD  
INVESTMENT COMMITTEE

SUBJECT: Alternative Investment Policies

Resolution No. \_\_\_\_\_

WHEREAS, the Investment Committee of the Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the State Teachers' Retirement System has contracted with Pathway Capital Management to perform ongoing alternative investment consulting services; and

WHEREAS, Pathway Capital Management and the STRS' Alternative Investment Staff have reviewed and revised the Alternative Investment Policies; and

WHEREAS, the Investment Committee adopted the Alternative Investment Policy and Procedures Manual, as amended, on June 3, 1998; and

WHEREAS, the Staff has incorporated changes to the Policies as directed; Therefore be it

RESOLVED, that the Investment Committee of the Teachers' Retirement Board adopts the Alternative Investment Policies to incorporate the changes: 1) Identification of the benchmark, 2) Requirement for an annual business plan, 3) Requirement for semi-annual performance reporting by Consultant.

Adopted by:  
Investment Committee  
on \_\_\_\_\_

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James D. Mosman  
Chief Executive Officer